WHITE PAPER - BANKING AND FINANCE

BIRD'S EYEVIEW[1]

Indian banking industry is expected to witness the roll out of innovative banking models like payments and small finance banks. 11 payment banks are expected to be launched in 2016 and 2017. Separately about 10 small finance banks are also expected to be launched. RBI's new measures may go a long way in helping the restructuring of the domestic banking industry. The Indian banking system consists of 26 public sector banks, 25 private sector banks, 43 foreign banks, 56 regional rural banks, 1,589 urban cooperative banks and 93,550 rural cooperative banks, in addition to cooperative credit institutions. Public-sector banks control nearly 80 percent of the market, thereby leaving comparatively much smaller shares for its private peers. Standard & Poor's estimates that credit growth in India's banking sector would improve to 12-13 per cent in FY16 from less than 10 per cent in the second half of CY14. In this background, is it imperitive that a well regulated banking and finance environment is required for further upping the investment activity. This white paper broadly deals with the legislative and regulatory aspects governing the Indian banking and financial sector.

LEGISLATIVE FRAMEWORK

The Regulator - The Reserve Bank of India

The Reserve Bank of India ("**RBI**"), as the central bank of the country, started their operations as a private shareholder's bank. RBI replaced the Imperial Bank of India and started issuing the currency notes and acting as the banker to the government. Imperial Bank of India was allowed to act as the agent of the RBI. RBI covered all over the undivided India. In order to have close integration between policies of the Reserve Bank and those of the Government, it was decided to nationalize the Reserve Bank immediately after the independence of the country. From 1st January 1949, the Reserve Bank began functioning as a State-owned and State-controlled Central Bank. To streamline the functioning of commercial banks, the Government of India enacted the Banking Companies Act, 1949 which was later changed as the Banking Regulation Act 1949. RBI acts as a regulator of banks, banker to the Government and banker's bank. It controls financial system in the country through various measures.

Applicable Banking Laws

RBI Act, 1934

The Reserve Bank of India Act, 1934 ("**RBI Act**") is a legislative act under which the Reserve Bank of India ("**RBI**") was formed and provided a framework for the supervision of banking companies in India. The RBI Act regulates, *inter alia* (i) the manner in which the RBI can conduct business; (ii) acceptance of deposits from the central and state governments; (iii) purchasing and discounting of bills of exchange from commercial banks; (iv) purchase/sale of foreign exchange from/to banks; (iv) providing loans to banks and state financial corporations; (v) providing advances to the central government and state governments; (vi) buying or selling government securities; (vii) dealing in derivative, repo and reverse repo; (viii) conducting the banking affairs for the central government and manage public debt; (ix) issuance of currency notes in India.

Banking and Regulation Act, 1949

[1]Source: http://www.ibef.org/industry/banking-india.aspx

The Banking Regulation Act, 1949 is a legislation regulating commercial banking in India and extends the RBI the power to license banks, have regulation over shareholding and voting rights of shareholders; supervise the appointment of the boards and management; regulate the operations of banks; lay down instructions for audits; control moratorium, mergers and liquidation; issue directives in the interests of public good and on banking policy, and impose penalties in cases of violations.

Recovery of Debts Due To Banks and Financial Institutions Act, 1993

The Recovery of Debts Due To Banks and Financial Institutions Act, 1993 ("**DRT Act**") provides for the expeditious adjudication and recovery of debts due to banks and financial institutions. It is a special act for recovery of debt and has an overriding effect over the provisions of the Companies Act, 2013. For recovery under the DRT Act, the Bank (either by itself or along with other bank(s)/financial institutions) would be required to file an application for recovery of loan taking into consideration the jurisdiction and cause of action. Considering that the Limitation Act, 1963 is also applicable on the cases being adjudicated under the DRT Act, the application must be filed by the bank or the financial institution within limitation period from cause of action.

The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 ("SARFAESI Act")

The SARFAESI Act provides for sale of financial assets by banks and financial institutions to asset reconstruction companies. The NPA Prudential Norms issued by the RBI prescribe the process to be followed for sales of financial assets to asset reconstruction companies. The banks may not sell financial assets at a contingent price with an agreement to bear a part of the shortfall on ultimate realisation. However, banks may sell specific financial assets with an agreement to share in any surplus realised by the asset reconstruction company in the future. Consideration for the sale may be in the form of cash, bonds or debentures or security receipts or pass through certificates issued by the asset reconstruction company or trusts set up by it to acquire the financial assets.

In January 2013, the SARFAESI Act was amended by the Enforcement of Security Interest and Recovery of Debt Laws (Amendment) Act, 2012. Pursuant to the amendment, means for recovery of assets available to banks and financial institutions have been strengthened. For instance, securitisation and reconstruction companies have been permitted to convert part of their debt into shares of a borrower company for the purpose of asset reconstruction. Further, banks and financial institutions have been empowered to accept immovable property in full or partial satisfaction of the bank's claim against the defaulting borrower in times when they cannot find a buyer for the securities. The amendment also enables banks and financial institutions to enter into settlement or compromise with the borrower and empowers DRTs to pass an order acknowledging any such settlement or compromise.

Presently, the SARFAESI Act is not available to NBFCs and there is no statutory backing available to NBFCs to recover their loans. However, during the session for the Union Budget of India, 2015, announced on February 28, 2015, the Finance Minister of India proposed that NBFCs with assets of ` 5,000 million and above will be allowed to use the SARFAESI Act like any other financial institution. However, in this regard as of date, no notifications/circulars/notices have been issued for amending the SARFAESI Act to include NBFCs-NDSI.

Transfer of Property Act, 1882

The Transfer of Property Act, 1882 ("**TPA**") was enacted to amend the law relating to transfer of property by act of parties. Thus, TPA applies only to voluntary transfer or property. It does not cover transfer of property by 'will'. It also details the general principles, such as, part -performance, lis pendens, sale, exchange, mortgage, lease, gift etc. The Bombay Act, 1954, has amended the TPA in Mumbai. Entry 6 of List III (Concurrent List) of Seventh Schedule to Constitution reads 'Transfer of property other than agricultural land; registration of deeds and documents'. Thus, transfer of property is a 'Concurrent Subject'. Both Central and State Government can take legislative action in respect of transfer of property except that relating to agricultural land. Section 4 of TPA clarifies that the part of TPA, which relates to contracts shall be taken as part of Indian Contract Act and some specified sections should be read as supplemental to Indian Registration Act. Thus, TPA is complimentary to Indian Contract Act and Registration Act. The TPA applies both to movable and immovable property. Under Section 54 of the TPA, a 'Sale' is a transfer of ownership in exchange for a price paid or promised or part-paid and part promised. Such transfer in case of tangible immovable property of value of Rs. 100 or more can be made only by a registered instrument. Delivery of tangible immovable property is mad e when seller places the buyer, or such person as he directs, in possession of property. Thus, delivery of immovable property can be only by handing over the actual possession of the immovable property to the buyer or to a person authorized by the buyer.

Registration Act, 1908

The Registration Act 1908 was enacted as a law, which seeks to conserve evidence, assurances, title, publication of documents, and prevention of fraud. It details formalities to register documents. Compulsorily registrable (to be presented to the correct office within 4 months of signing) are documents that record – (i) gifts of immovable property; (ii) other non-testamentary documents that create, declare, assign, limit or extinguish, whether in present or in future, any right, title or interest, whether vested or contingent, to or in immovable property; (iii) non-testamentary documents which acknowledge receipt or payment of any consideration on account of instrum ents in (ii) above; (iv) leases of immovable property from year to year, or for any term exceeding one year, or reserving a yearly rent. The Act also specifies that an unregistered document will not (a) affect the property to which it relates; and (b) be received as evidence of the property transaction, which it records (except as evidence of a contract in a suit for specific performance or as evidence of part-performance under the TPA or as a collateral.

Prevention of Money Laundering Act, 2002 ("PMLA")

PMLA was enacted to prevent money-laundering and to provide for confiscation of property derived from or involved in, money-laundering. Further, The Prevention of Money–Laundering (Maintenance of Records) Rules, 2005 ("**Rules**") was enacted for maintenance of records of the nature and value of transactions, the procedure and manner of maintaining and time for furnishing of information and verification of records of the identity of the clients of the banking companies, financial institutions and intermediaries. PMLA and the Rules extend to all banking companies and financial institutions, including NBFC's and intermediaries.

The RBI pursuant to a master circular dated July 1, 2015 set out obligations of NBFC's in terms of the Rules to ensure that a proper policy frame work for the PMLA is put in place. Pursuant to the provisions of PMLA, the Rules and the RBI guidelines, all NBFCs are advised to appoint a principal officer and put in place a system of internal reporting to Financial Intelligence Unit - India of suspicious transactions and cash transactions. NBFCs were further required to introduce a system of maintaining proper record of transactions as prescribed under the Rules and as set out below:

a. all cash transactions of value of more than INR. 1 million or its equivalent in foreign currency;

b. all series of cash transactions integrally connected to each other which have been valued below one million or its equivalent in foreign currency, where such series of transactions have taken place within a month and the aggregate value of such transaction exceeds INR. 1 million;

c. all cash transactions where forged or counterfeit currency notes or bank notes have been used as genuine and where any forgery of a valuable security has taken place;

d. all suspicious transactions whether or not made in cash and in manner as mentioned in the rules framed by Government of Indian under the Prevention of Money Laundering Act, 2002.

Additionally, NBFCs should ensure that records pertaining to the identification of their customers and their address are obtained while opening the account and during the course of business relationship, and that the same are properly preserved for at least ten years after the business relationship is ended. The identification records and transaction data is to be made available to the competent authorities upon request.

Taxation Laws applicable in banking operations

Like any other business units, companies, banks and financial institutions are required to ensure that all the applicable provisions of the various tax laws (Income Tax Act, Finance Act etc) to deduct and pay income tax, professional tax, service tax etc. As an employer as well as the beneficiary of different services, banks are required to adhere to the applicable tax provisions. Apart from the role of employer and beneficiary of services, banks are expected to pay tax on the interest payable to the customers as per the directives of authorities like TDS on interest payable on fixed deposits, NRO deposits, etc. Apart from the above, income on investments made by the bank and dealing in securities by banks , also attract provisions of TDS.

Limitation Act, 1963

The Limitation Act, 1963 specifies certain period prescribed within which any suit appeal or application can be made. The 'prescribed period' means the period of limitation computed in accordance with the provisions of the Limitation Act. A banker is allowed to take legal action by filing a suit, prefer an appeal and apply for recovery only when the documents are within the period of limitation. On the other hand, if the documents expired or are time barred, the banker cannot take any legal course of action to recover the dues. It is the responsibility of lenders to ensure that all loan documents are properly executed and they are all within the required limitation period as per the limitation act. This is one of the crucial aspect in credit management of banks. The period of limitation and the time from which the period begins to run is shown below:

Nature of Documents	Limitation Period
A Demand Promissory Note	Three years from the date of DP Note.
A Bill of exchange payable at sight or under presentation	Three years when the bill is presented
An Usance Bill of exchange	Three years from the due date
Money payable for money lent	Three years from the loan was made.
A guarantee	Three years from the date of invocation of the guarantee
A mortgage - enforcement of payment of money	Twelve years from the date the money sued becomes due
A mortgage – foreclosure	Twelve years from the money secured by the mortgage becomes due
A mortgage - possession of Immovable property	Thirty years when the mortgagee becomes entitled to possession

Kinds of Securities for Financing

Reference of Security	Advantages	Disadvantages
Land/Real Estate	• Its value generally increases with time. With every fall in the value of money, the value of land goes up and due to its scant availability in developing areas its value is bound to increase. • It cannot be shifted, a fact which sometimes is also a disadvantage.	• Valuation is at times difficult. • The banker cannot obtain a proper title unless the borrower himself has title to the property to be mortgaged. • Difficult to realize the security. • Creating a charge is costly. • In the case of buildings, which come within the purview of the Rent Control Act, it would be difficult to sell the building, particularly when a tenant has been occupying it for a long time.
Stocks and Shares	• Value of the security can be ascertained without any difficulty. • In normal times, stocks and shares enjoy stability of value and are not subject to wide fluctuations. • Stocks and shares require very little formalities, for taking them as security. • It is easier compared to real estate to ascertain the title, more so with the advent of depositories. • Creating a charge of this is less expensive than real estate. • They yield income by way of dividends, which can be appropriated towards the loan account. • Being a tangible form of securities they are more reliable. • The release of such securities involves very little expense and formality.	• Being easy to realize, they are fraud prone and as such they must be properly secured. • In the case of partly paid shares, the following demerits are there: (a) The banker may have to pay the calls. (b) Partly paid shares are subject to violent price fluctuations. • They are not easily realizable because of the restricted market for such share.
Debentures	• Easy to sell. • Not subject to violent price fluctuations.	• If interest is not paid regularly on the debentures it would affect its price and

	• They can be transferred at minimum cost. • Bearer debentures are fully negotiable. • They rank in priority to shares and mostly secured by a charge on the company's property.	marketability. • If the charge on property of company is not registered, the subsequent charges will get a priority. • Debentures may be issued by companies having no power to borrow money.
Goods	• Goods have a ready market and as such can be easily sold unlike other kinds of security. • Valuation of the goods can be easily done. • The banker gets a tangible form of security compared to unsecured advances, which in case of default by the borrower, can be realized by sale of pledged goods. • Advances against goods are normally given for short periods and therefore the risk of the banker is considerably reduced. • Barring a few states where the stamp duty is heavy, creating a charge on the security is less costly and involves minimum formalities. • Banker acquires a good title to the goods when dealing with customers of repute and standing	• Certain goods are liable to perish or deteriorate in quality over a period of time, thus resulting in reduction of the value of the banker's security. • There are possible risks of fraud or dishonesty on the part of the borrower. For example, when 10,000 tins of cashew nuts are shown in the godown as security for an advance, it is not possible for the banker to verify the quality and quantity in every tin. It is not even possible to verify whether all the 10,000 tins contain cashew nuts. A fraudulent borrower may not store the full stocks as declared in the godown. • The value of the security in certain cases more particularly electronic consumer goods are subject to wide fluctuations. Therefore, the valuation of such goods is difficult. Even in the case of necessaries, there being several varieties, unless the banker has expert knowledge, the valuation may be misleading. Disposing of large quantities of goods within a short time may be difficult and may not fetch the expected/ declared price. • The banker may find it difficult to store the goods. • Transporting the goods from the borrower's premises to the banker's premises and thereafter to the market in case of sale is a considerably costly and time-consuming affair.

		• When the banker releases goods for sale on the execution of trust receipts, the money realized by the sale of such goods may not be deposited with the banker, and the borrowers may default to the bankers. • If the goods are warehoused, the warehouse keeper enjoys a lien over the goods for any unpaid charges. The banker therefore, has to ensure periodically that all charges are duly paid.
Life Policies	• Life insurance business being highly regulated and permitted only to companies having sound financial health, the banker need not doubt the realisation of the policies, which will be done without any difficulty, if the policy and the claim are in order. • The assignment of the policy in favour of the banker requires very little formalities and the banker obtains a perfect title. • The longer the period for which the policy has been in force, the greater the surrender value. It is also useful as an additional security because, in the event of the borrower's death, the debt is easily liquidated from the proceeds of the policy. • The security can be realized immediately on the borrower's default of payment by surrendering the policy to the insurance company. • The policy is a tangible security and is in the custody of the bank. The banker only has to ensure that regular payment of premiums is made	• If the premium is not paid regularly, the policy lapses and reviving the policy is complicated. • Insurance contracts being contracts of utmost good faith, any misrepresentation or non-disclosure of any particulars by the assured would make the policy void and enable the insurer to avoid the contract. • The person (proposer) who has obtained the policy must have an insurable interest in the life of the assured or the contract is void. • The policy may contain special clauses, which may restrict the liability of the insurer. • When the banker accepts a policy coming under Married Women Property Act he must ensure that all the parties sign in the bank's form of assignment. • There is facility to obtain the duplicate policy if the original is lost. This can be misused by persons by obtaining duplicate policies. Banker should therefore, verify that no duplicate policy has been issued and there are no encumbrances on the policy.

Creation of charge over Securities

Charging a security means that the borrower gives the lender a right to: (i) transfer the title from the borrower to the lender (ii) take possession of the securities (iii) recover the dues through legal course

Creation of charge on securities is done as per the nature of the security as under:

1. Hypothecation (for movable stocks such as, goods, plant and machinery)
2. Pledge (for movable stocks)
3. Mortgage (in respect of immovable property)
4. Assignment of debts (life like insurance policy/book debts)
5. Lien on deposits with the bank

Hypothecation

Meaning

The term "Hypothecation' means a charge created on any movable asset/property, for a loan borrowed by the owner of goods/movable assets (existing or future) without transferring, either the property or the possession to the lender.

The SARFAESI Act defines hypothecation as:

"hypothecation means a charge in or upon any movable property, existing or future, created by a borrower in favour of a secured creditor without delivery of possession of the movable property to such creditor, as a security for financial assistance and includes floating charge and crystallisation of such charge into fixed charge on movable property"

Important Features of Hypothecation

- The charge hypothecation is applicable to movable assets.
- The ownership and possession are held by the borrower of the assets (security).
- The document (hypothecation agreement) provides for a covenant, whereby the borrower agrees to give possession of the goods (movable assets) when called upon to do so by the creditor. Upon taking over the possession of goods, the charge is treated as pledge.
- The possession of the goods/assets are held by the borrower, hence, it is always difficult for the creditor (lender) to have control over such goods.
- The borrower may sell the hypothecated stocks, and pay other creditors.
- The possibility of raising double finance against the same stock cannot be ruled out. For example the borrower may hypothecate the same stocks to another bank, the goods may be latter pledged to another creditor.
- In case of default, the realization of assets may be difficult and costly.

Difference between Hypothecation and Pledge

Hypothecation	Pledge
Applicable to movable goods/assets	Applicable to movable goods/assets
Ownership remains with the borrower	Ownership remains with the borrower
Possession remains with the borrower	Possession is held by the lender
Defined under SARFAESI Act	Defined under Indian Contract Act
Legal document is hypothecation agreement	Legal document is deed of pledge

In case the borrower is a Limited Company registration of charge with ROC is a must	In case the borrower is a Limited Company registration of charge with ROC is not applicable

Pledge of Security

Meaning

Pledge means bailment of goods for the purpose of providing security for payment of debt or performance of promise. Section 172 of Indian Contract Act, 1872 defines pledge. The requirements for a valid pledge are:

- There should be delivery of goods (bailment).
- The bailment (delivery of goods) must be by or on behalf of the debtor.
- The bailment (delivery of goods) must be for the purpose of providing security for the payment of a debt or performance of a promise.

Important features of Pledge

- The person, whose goods are bailed is called pawnor or pledger, and to whom the goods are pledged as pawnee or pledgee.

- Ownership of the property is retained by the pledger, which is subject only to the qualified interest which passes to the pledgee by the bailment.

- The essential feature of a pledge is the actual or constructive delivery of the goods to the pledgee. By constructive delivery it is meant that there will be no physical transfer of goods from the custody of the pledger/ pawnor to the pledge/ pawnee. All that is required is that the goods must be placed in the possession of the pawnee or of any person authorized to hold them on his behalf.

- The delivery of the goods may be 'physical' when goods are actually transferred and 'symbolic' as in the case of delivery of the key or'constructive' as in the case of attornment.

- Pledge can be created only in the case of existing goods (and not on future goods) which are in the possession of the pledger himself.

- Since the possession of goods is the important feature of pledge and therefore, pledge is lost when possession of the goods is lost.

- An agreement of pledge also known as deed of pledge may be implied from the nature of the transaction or the circumstances of the case.

- To protect the interests of the concerned parties the agreement in writing should clearly indicate the terms and conditions.

A valid pledge can be created by (i) the owner of the goods (ii) a mercantile agent, subject to the following terms and conditions are satisfied (iii) the seller of goods, who continues to hold the goods even after sale, can create a valid pledge. The pledgee must act in good faith and without notice of the previous sale.

Rights of Pledgee

1. Right of Retainer: As per Section 173 of the Indian Contract Act, 1872, the pawnee or pledge is entitled to the good pledged not only for non-payment of debt or non- performance of promise, but also for the interest on the debt and for all expense incurred for preservation of the goods pledged.

2. Right against Third Parties: A pledge has the same remedies against third persons, as the owner himself would have, if he is deprived of his goods.

3. No Right to Retain in case of Other Debts: In the absence of a contract to the contrary, the pledge cannot retain goods for a debt or a promise, other than the promise or debt for which the said goods are pledged.

4. Other rights: In case the Pledger makes default, then the Pledgee has three important rights: (i) He may sue the pawnor upon the debt or promise (ii) He may retain the pledged goods as collateral security; or (iii) He may sell it after giving the pledger reasonable notice of the sale.

Mortgage

Introduction

Section 58(a) of the Transfer of Property Act, 1882 defines a mortgage as follows: 'A mortgage is the transfer of interest in specific immoveable property, for the purpose of securing the payment of money advanced or to be advanced by way of loan, on existing or future debt or the performance of an engagement which may give rise to a pecuniary liability.' The transferor is called the 'mortgagor' and the transferee a 'mortgagee' the principal money and interest of which payment is secured is called mortgage money and the instrument by which the transfer is effected is called the 'mortgage deed'.

Ingredients of Mortgage

- There should be transfer of interest in the property by the mortgagor (the owner or lessor).
- The transfer should be to secure the money paid or to be paid by way of loan.

Types of Mortgage

- Simple mortgage
- Mortgage by conditional sale
- Usufructuary mortgage
- English mortgage
- Mortgage by deposit of title deeds (Equitable mortgage)
- Anomalous mortgage

Simple Mortgage

According to Section 58(b) of the Transfer of Property Act, a simple mortgage is a transaction whereby, 'without delivering possession of the mortgaged property, the mortgagor binds himself personally to pay the mortgage money and agrees, expressly or impliedly, that in the event of his failing to pay according to his contract, the mortgagee shall have a right to cause the mortgaged property to be sold by a decree of the Court in a suit and the proceeds of the sale to be applied so far as may be necessary in payment of the mortgage money. Features of simple mortgage are as follows:

- The mortgagee has no power to sell the property without the intervention of the court In case there is shortfall in the amount recovered even after sale of the mortgaged property the mortgagor continues to be personally liable for the shortfall.
- The mortgagee has no right to get any payments out of the rents and produce of the mortgaged property
- The mortgagee is not put in possession of the property
- Registration is mandatory if the principal amount secured is INR. 100 and above

Mortgage by way of conditional sale

As per Section 58(c) of the Transfer of Property Act, a mortgage by way of a conditional sale of the property, is a transaction whereby, the mortgagor ostensibly sells the mortgaged property on the condition that: (a) on default of payment of the mortgage money on a certain date, the sale shall become absolute, or (b) on such payment being made the sale shall become void; or (c) on such payment being made, the buyer shall transfer the property to the seller. No such transaction shall be deemed to be a mortgage of conditional sale, unless the condition is embodied in the document, which effects or purports to effect the sale. Features of mortgage by way of conditional sale are as follows:

- The sale is ostensible and not real.
- If the money is not repaid on the agreed date, the ostensible sale will become absolute upon the mortgagor applying to the Court and getting a decree in his favour. The mortgagor in such a case loses his right to redeem his property.
- The mortgagee can sue for foreclosure, but not for sale of the property. Foreclosure, means the loss of the right possessed by the mortgagor to redeem the mortgaged property.
- There is no personal covenant for repayment of the debt and therefore bankers do not prefer this type of mortgage. The mortgagee cannot look to the other properties of the mortgagor in case the mortgaged property proves insufficient.

Usufructuary Mortgage

According to Section 58(d) of the Transfer of Property Act, 'a Usufructuary mortgage is a transaction in which (a) the mortgagor delivers possession expressly, or by implication and binds himself to deliver possession of the mortgaged property to the mortgagee, and (b) authorizes the mortgagee, to retain such possession until payment of the mortgage money and to receive the rents and profits accruing from the property or any part of such rents and profits and to appropriate the same in lieu of interest, or in payment of the mortgage money, or partly in lieu of interest and partly in payment of the mortgage money. Essential features of Usufructuary mortgage are as follows:

- The mortgagee is put in possession of the mortgaged property. Here, by possession it is meant, the legal possession and not the physical possession. For example, the mortgagor may continue to enjoy the physical possession as the lessee of the mortgagee or the mortgagor may be the caretaker of the property directing the tenants to pay rent to the mortgagee. However, the deed must contain a clause providing for the delivery of the property to the mortgagee and authorizing him to retain such possession.
- The mortgagee has the right to receive the rents and profits accruing from the property. Such rents and profits or part thereof, may be appropriated in lieu, of interest or in payment of the mortgage money or partly for both.
- Unless there is a personal covenant for the repayment of the mortgage money, there is no personal liability for the mortgagor. Therefore, the mortgagee cannot sue the mortgagor for repayment of the mortgage debt; nor can he sue mortgagor for the sale or foreclosure of the mortgaged property.

- There is no time limit specified and the mortgagee remains in possession of the property until the debt is repaid. The only remedy for the mortgagee is to remain in possession of the mortgaged property and pay themselves out of the rents and or profits of the mortgaged property. If the mortgagor fails to sue for redemption within thirty years, the mortgagee becomes the absolute owner of the property.

This form of mortagage is not preferred by the bankers because of the following reasons:

- There is no personal covenant to repay the debt.
- As the mortgaged money can be recovered only by the appropriation of rents and/or profits, it will take a very long time to recover money through this process.

English Mortgage

According to Section 58(e) of the Transfer of Property Act, an 'English Mortgage' is a transaction in which, the mortgagor binds himself 'to repay the mortgage money on a certain date and transfers the mortgaged property absolutely to the mortgagee, but subject to the provision that he will retransfer it to the mortgagor upon payment of the mortgage money as agreed'. Essential features of English Mortgage are as follows:

- It provides for a personal covenant to pay on a specified date notwithstanding the absolute transfer of the property to the mortgagee.
- There is an absolute transfer of the property in favour of the mortgagee. However, such absolute transfer is subject to a provision that the property shall be re-conveyed to the mortgagor in the event of the repayment of mortgage money.
- The mortgagee can sue the mortgagor for the recovery of the money and can obtain a decree for sale.

Mortgage by deposit of title deeds

According to Section 58(f) of the Transfer of Property Act, 'Where a person in any of the following towns, namely, the towns of Kolkata, Chennai and Mumbai and in any other town which the State Government concerned may, by notification in the official Gazette, specify in this behalf, delivers to a creditor or his agent documents of title to immoveable property, with intent to create a security thereon, the transaction is called a mortgage by deposit of title deeds,'.

Documents of title or title deed in case of mortgage by deposit of title deeds, shall be documents or instruments which relate to ownership of the mortgagor over the property. In other words, by virtue of a document or instrument, if a person has a right to peaceful possession and enjoyment of the immoveable property, then such a document or instrument is called the title deed. The essential features of equitable mortgage are as follows:

- Such a mortgage can be affected only in the towns notified by the State Government. However, the territorial restriction refers to the place where the title deeds are delivered and not to the situation of the property mortgaged.
- To create this mortgage, there must be three ingredients i.e., a debt, a deposit of title deeds and an intention that the deeds shall be act as security for the debt.

Anomalous mortgage

According to Section 58(g) of the Transfer of Property Act, 'a mortgage which is not a simple mortgage, a mortgage by conditional sale and usufructuary mortgage and English mortgage or a mortgage by deposit of title deeds within the meaning of this Section, is called an "Anomalous Mortgage. The essential features of anomalous mortgage are as follows:

- It must be a mortgage as defined by Section 58 of the Transfer of Property Act.
- It is negatively defined and should not be anyone of the mortgages listed above.
- Anomalous mortgages are usually a combination of two mortgages. Examples of such mortgages are: (a) a simple and usufructuary mortgage, and (b) an usufructuary mortgage accompanied by conditional sale. There may be other forms, molded by custom and local usage.

Priority of Mortgages

Indian Law of priorities is provided in Section 48 of the Transfer of Property Act. The rule is based on maxim 'he has a better title who was first in point of time.' It lays the general rule regarding priority of rights created by transfer by a person at different times in or over the same immoveable property and provides that, as between such rights, each later created right is subject to the rights previously created.

(a) Priority among registered instruments

Section 47 of the Registration Act, 1908 provides that a registered document operates, not from the date of its registration, but from the time of its execution. Thus, a document executed earlier, though registered later than another, has priority over the documents executed later.

(b) Priority between registered and unregistered instruments

Dealing with the exceptions to the rule, that priority is determined by order of time, which either have been created by statute or owe their origin to the ancient rule of Hindu Law, which required delivery of possession in the case of a security of land. There are also some exceptions recognized in the Indian system founded upon those general principles of justice and equity, which in the absence of any express enactment, Indian judges are bound to administer, and which, have been mostly borrowed, from the English Law. The first exception is that contained in Section 50 of the Registration Act, which under certain circumstances allows a registered mortgage priority over unregistered mortgage. However, it may be noted that prior mortgage by deposit of title deeds is not affected by subsequent registered mortgage as the same need not be registered. This, is provided in Section 48 of Indian Registration Act.

Limitation period in Mortgages

Article 62 of the Indian Limitation Act, 1963 provides limitation period for filing of suit for recovery of mortgaged debt and sale of mortgaged property in the event of non-payment of the mortgaged debt. Article 63(a) of the said Act provides a limitation period, in case of foreclosure of the mortgaged property. The limitation period for filing a suit for sale of mortgaged property is twelve years, from the date the mortgage debt becomes due. The limitation period for filing suit, for foreclosure is thirty years, from the date the money secured by mortgage becomes due.

Enforcement of Mortgages – Important aspects

Enforcement of all these types of mortgages is by way of filing a suit for sale of mortgaged properties. The procedure for filing a suit for a sale is provided for in the Code of Civil Procedure, 1908. The Section 16(c) of the Civil Procedure provides that a suit for sale of mortgaged property shall be filed in the Court within whose jurisdiction the mortgaged property is situated. Order 34 of the Code provides for various things to be adhered to while filing suit for sale of mortgaged property. When a suit for sale is filed, the Court after hearing the parties passes a preliminary decree. Through the preliminary decree it directs the mortgagor to pay the mortgage debt within a certain period and in the event of his failure to pay the money due under the mortgage, the Court orders for sale of mortgaged properties by passing a final decree. After passing of the final decree, the mortgagee with the help of the Court gets the mortgaged property sold in execution of the mortgage decree.

REGULATORY FRAMEWORK

Regulatory framework governing NBFCs

Revised Regulatory Framework for NBFCs

Previously, NBFCs were categorized into three groups for the purpose of administering prudential regulations, namely, NBFCs-D (with assets less than INR. 10 million) and NBFCs-ND-SI (with assets INR. 1,000 million and above). However, in light of the overall increase in the growth of the NBFC sector, the RBI, issued Revised Regulatory Framework for NBFCs on November 10, 2014, ("**Revised Regulatory Framework**") whereby it increased the threshold for categorization of NBFCs as systemically important and presently all NBFCs-ND having an asset size of INR. 5,000 million and above as per the last audited balance sheet are recognized as NBFCs-ND-SI. The Revised Regulatory Framework also lays down that NBFCs who are part of a corporate group or are floated by a common set of promoters shall not be viewed on a standalone basis. The framework also lays down the definition of the 'group' to align it as per Accounting Standards as laid down by the ICAI.

Master Circular - Systemically Important Non-Banking Financial (Non-Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2015 dated July 1, 2015

The RBI issued the Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions, 1998 on January 31, 1998, which were replaced by Non-Banking Financial (Non-Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007 dated February 22, 2007 and again superseded by the Revised Regulatory Framework. Further, to the Revised Regulatory Framework, RBI also issued the Systemically Important Non-Banking Financial (Non-Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2015 ("**RBI Directions**") dated March 27, 2015 laying down provisions governing NBFCs-ND-SI and are applicable to all NBFCs registered and operating as NBFCs-ND-SI. The RBI Directions prescribe guidelines regarding income recognition, assets classification, provisioning requirements, credit concentration norms and capital adequacy requirements.

<u>Income recognition</u>

The RBI Directions require that income recognition shall be based on recognized accounting principles. Income including interest, discount, hire charges, lease rentals and any other charges on the NBFC's non-performing assets ("**NPAs**") shall be recognised only when it is actually realised. Any such income recognised before the asset became non-performing and remaining unrealized are required to be reversed.

<u>Income from investments</u>

The RBI Directions further provide that income from dividend on shares of corporate bodies and units of mutual funds shall be taken into account on cash basis. However, the income from dividend on shares of corporate bodies may be taken into account on accrual basis where such dividend has been declared by the corporate body in its annual general meeting and the right to receive payment has been established. Income from bonds and debentures of corporate bodies and from

Government securities or Government bonds may be taken into account on accrual basis provided that the interest rate on these instruments is pre-determined and interest is serviced regularly and is not in arrears. Income on securities of corporate bodies or public sector undertakings, the payment of interest and repayment of principal of which have been guaranteed by Central Government or a State Government may be taken into account on accrual basis.

Asset Classification

As per the RBI Directions, every NBFC shall, after taking into account the degree of well-defined credit weaknesses and extent of dependence on collateral security for realisation, classify its lease or hire purchase assets, loans and advances and any other forms of credit into (i) standard assets; (ii) sub-standard assets; (iii) doubtful assets; and (iv) loss assets. These classes of assets shall not be upgraded merely as a result of rescheduling, unless they satisfy the provisioning requirements laid down under the RBI Directions and required for upgradation of an asset's classification.

Presently, an asset is classified as non-performing (i) if it has remained overdue for a period of six months or more in the case of loans; and (ii) if it has remained overdue for a period of twelve months or more in the case of lease rental and hire purchase instalments. However, in the interest of harmonisation of asset classification by banks and NBFCs, the RBI Directions aim to bring in line the asset classification norms for NBFCs with that of banks, in a phased manner, as given below:

Lease rental and hire-purchase assets shall become NPA:

i. if they become overdue for 9 months for the Fiscal ending March 31, 2016;

ii. if overdue for 6 months for the Fiscal ending March 31, 2017; and

iii. if overdue for 3 months for the Fiscal ending March 31, 2018 and thereafter.

Assets other than lease rental and hire-purchase assets shall become NPA:

i. if they become overdue for 5 months for the Fiscal ending March 31, 2016

ii. if overdue for 4 months for the Fiscal ending March 31, 2017; and

iii. if overdue for 3 months for the Fiscal ending March 31, 2018 and thereafter.

For all loan and hire-purchase and lease assets, sub-standard assets would mean:

i. an asset that has been classified as NPA for a period not exceeding 16 months (currently 18 months) for the Fiscal ending March 31, 2016;

ii. an asset that has been classified as NPA for a period not exceeding 14 months for the Fiscal ending March 31, 2017; and

iii. an asset that has been classified as NPA for a period not exceeding 12 months for the Fiscal ending March 31, 2018 and thereafter.

Doubtful asset would mean:

i. an asset that has remained sub-standard for a period exceeding 16 months (currently 18 months) for the Fiscal ending March 31, 2016;

ii. an asset that has remained sub-standard for a period exceeding 14 months for the Fiscal ending March 31, 2017

iii. an asset that has remained sub-standard for a period exceeding 12 months for the Fiscal ending March 31, 2018 and thereafter.

For the existing loans, a one-time adjustment of the repayment schedule, which shall not amount to restructuring will, however, be permitted as per the RBI Directions.

Provisioning Requirements

The Directions prescribe that every NBFC shall after taking into account the time lag between an account becoming nonperforming, its recognition as such, the realisation of the security and the erosion over time in the value of security charged, make provision against sub-standard assets, doubtful assets and loss assets as provided for in the RBI Directions. At present every NBFC is required to make provisions for standard assets at 0.25% by the end of March 2015; 0.30% by the end of March 2016; 0.35% by the end of March 2017 and 0.40% by the end of March 2018 and thereafter, of the outstanding which shall not be reckoned for arriving at net NPAs. However, the provisions towards standard assets need not be netted from gross advances but shall be shown separately as 'Contingent Provisions against Standard Assets' in the respective NBFC's balance sheet.

Accounting disclosures, Accounting year & Auditor's Certificate

The provisioning requirements are to be distinctly indicated under separate heads of accounts as per the RBI Directions. Further, NBFCs are also required to disclose particulars of their capital to risk assets ratio; exposure to real estate sector (both direct and indirect); and the maturity pattern of their assets and liabilities.

Every NBFC is required to prepare its balance sheet and profit and loss account as of March 31 every year in accordance with the provisions of the Companies Act, 2013. Whenever an NBFC intends to extend the date of its balance sheet, it is required to take prior approval of the RBI before approaching the concerned registrar of companies. In case the RBI and the concerned registrar of companies grant extension of time, the NBFC is required to furnish an unaudited proforma balance sheet and statutory returns as of March 31 of the year under consideration. Every NBFC is required to finalise its balance sheet within a period of three months of the date to which it pertains.

NBFCs are also required to submit a certificate from its statutory auditor certifying thereto that the NBFC is engaged in the business of non-banking financial institution requiring it to hold a CoR under Section 45-IA of the RBI Act and is eligible to hold the CoR. The certificate shall also indicate the asset / income pattern of the NBFC for making it eligible for classification as asset finance company, investment company or loan company.

Capital Adequacy Norms

In terms of the Directions, every NBFC shall maintain a minimum capital ratio consisting of Tier I and Tier II capital which shall not be less than 15% of its aggregate risk weighted assets on-balance sheet and of risk adjusted value of offbalance sheet items. The total of Tier I capital, at any point of time, shall not be less than 8.5% by March 31, 2016 and 10% by March 31, 2017.

Non-Banking Financial Companies Corporate Governance (Reserve Bank) Directions, 2015 ("Corporate Governance Guidelines")

RBI has prescribed Corporate Governance Guidelines dated April 10, 2015 to enable NBFC's to adopt best practices and greater transparency in their operations. Every NBFC-ND and NBFC-ND-SI is required to adhere to corporate governance norms, set out in these directions which include constitution of an audit committee, a nomination committee, and a risk management committee. The audit committee and the nomination committee shall exercise the same powers, functions and duties as is laid down under the Companies Act, 2013.

Banking Ombudsman

Banking Ombudsman Service is a grievance redressal system. This service is available for complaints against a bank's deficiency of service. A bank's customer can submit complaint against the deficiency in the service of the bank's branch and bank as applicable, and if he does not receive a satisfactory response from the bank, he can approach Banking Ombudsman for further action. Banking Ombudsman is appointed by RBI under Banking Ombudsman Scheme, 2006. RBI as per Sec 35 A of the Banking Regulation Act, 1949 introduced the Banking Ombudsman Scheme with effect from 1995.

External Commercial Borrowing ('ECB")

The policy of the RBI relating to ECB is consolidated in the Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations, 2000, and as read with the RBI‟s Master Circular on ECBs and Trade Credits issued from time to time with a sunset clause of one year.

Subject to certain basic eligibility criteria, ECB can be accessed under two routes, viz. the (i) automatic route, and (ii) approval route. Under the automatic route, NBFCs which are infrastructure finance companies are recognised as eligible borrowers. Recognised lenders include internationally recognised sources such as international banks, international capital markets, multilateral financial institutions or regional financial institutions and Government-owned development financial institutions, export credit agencies, suppliers of equipments, foreign collaborators, and foreign equity holders (other than erstwhile 'Overseas Corporate Bodies'). ECB is subject to certain end-use stipulations, including that it may not be used for working capital, general corporate purposes and repayment of Rupee loans.

HOW CAN WE ASSIST

ARA LAW's expertise in banking and finance covers acquisition & leverage finance, structured finance, global loans, restructuring, external commercial borrowings, asset securitisation and various regulatory issues pertaining to the area. The firm has advised on complex transactions and has a deep understanding of the regulatory issues involved. The firm regularly interacts with the RBI and other financial intermediaries and offers practical advise on the client requirements. Our banking and finance practice is headed by Mr. Rajesh N. Begur who is assisted by a team of lawyers based out of Mumbai and Bengaluru.